

MARKET REVIEW

31-Oct-2009

International Economic Review

United States

The US economy expanded 0.9% (or 3.5% quarterly annualised) in the September quarter, marking the first increase after four consecutive quarters of contractions. Consumer spending and residential investment were particularly strong, buoyed by Government stimulus measures.

On more recent data, the ISM Manufacturing Index slipped 0.3 points to 52.6 in September, remaining above the 50 point threshold which is associated with expansion in the manufacturing sector. The more upbeat news was the release of the Non-Manufacturing ISM Index which rose above 50 for the first time in 12 months to 50.9 in September.

Not so encouraging was the labour market report. The Non-Farm Payroll fell 263,000 in September. Unemployment rose by 0.1% to 9.8%, with the number of Americans to have lost their job since the onset of recession in December 2007 having reached 7.6 million.

The continued weakness in the labour market led to pessimism in confidence surveys last month. The Conference Board's Consumer Sentiment Index fell 5.7 points to 47.7 in October, while the similar measure issued by the University of Michigan also fell 4.1 points to 69.4. Retail sales fell 1.5% in September but the number looks to have been affected by the wind down of the Government's "Cash-for-klunkers" program - an incentive to trade in old cars for new ones. Sales excluding autos rose 0.5%.

The news from the country's housing market continued to be mixed. Sales of new homes unexpectedly fell by 3.6% in September, but sales of existing homes surged by 9.4%. The S&P/Case-Shiller Index of house prices rose for the fourth consecutive month in August, by 1.2%.

Headline CPI rose 0.2% in September following a 0.4% rise in the previous month. Core CPI also rose 0.2% after increasing 0.1% in August. In annual terms, headline CPI remained in negative territory at -1.3%, while core CPI is 1.5% higher than a year ago.

Europe

The PMI Manufacturing Survey rose 1.4 points to 50.7, the first reading above 50 in more than a year. The closely-watched outlook indicator, the German IFO Index, rose 0.6 points in October to 91.9, while the ZEW Economic Sentiment Index was down 1.7 points to 56.0 in October.

The UK economy remained in deep recession following much weaker than expected September quarter GDP figures. The economy contracted 0.4% in the quarter and marked the sixth straight quarter of contraction.

Asia

Ahead of many expectations, China's GDP rose by 8.9% for the year ended September, up from 7.9% in the previous quarter. Fixed investment was the key driver of growth for the quarter which reflected the Government's strong stimulus packages. Meanwhile, inflation remained deflationary with consumer prices falling 0.8% in the year to September. The closely watched PMI surveys moved in different directions for September but both stayed above the expansionary threshold of 50 points.

In Japan, Industrial Production rose 1.4% in September but remained 18.9% lower than a year ago. In the labour market, employment data was better than expected with employment rising 40,000 in September, the second increase in a row, but still down 1.5% from a year ago. Pleasingly, the unemployment rate also fell by 0.2% to 5.3%. However, deflation continues to grip Japan with national CPI standing at -2.2% from a year ago.

Australia

The annualised growth rate of the Westpac/Melbourne Institute Leading Index, which indicates the likely pace of economic activity three to nine months ahead, continued to improve, rising to 1.7% in August from -1.1% in July. It remained below its long-term trend of 2.8%, but a marked improvement from -6.9% recorded in May.

Economic data released last month was broadly stronger with the labour market survey being a clear stand out. The level of employment rose 40,600 for the month with most of the rise attributed to full time jobs, reversing the fall in the previous month. Pleasingly, the unemployment rate fell 0.1% to 5.7%; a much better than expected result which was achieved despite a higher participation rate. The Westpac-Melbourne Institute Index of Consumer Sentiment rose 1.7% in October, marking its fifth consecutive monthly gain.

Private credit growth fell 0.2% in September to be 1.7% higher than a year ago, representing a 16-year low in credit growth. The weakness was led by business and personal loans, while housing credit was marginally higher. Meanwhile the NAB Business Conditions and Confidence Survey slipped in September following recent rises.

Headline CPI rose 1.0% for the September quarter and brought the annual rate to 1.3% compared to 1.5% recorded in the June quarter. The annual rate core measures, the trimmed mean and weighted median, eased to 3.2% and 3.8% respectively despite rising 0.8% each for the quarter.

International Sharemarket Review

Global sharemarkets rose during the first half of the month, led by the strong performance of the US market on the back of their better than expected reporting season. However, the gains faltered in the latter half of the month on rising risk aversion and concern over the sustainability of the economic recovery, particularly in the US. Energy stocks rose higher, benefiting from a stronger crude price, while cyclical sectors lagged behind. Financial stocks were also a notable underperformer.

Major bourses performed for the month as follows:

Japan Nikkei 225	-1.0%
UK FTSE 100	-1.7%
US Dow Jones	0.0%
US S&P 500	-2.0%
German DAX	-4.6%

Australian Sharemarket Review

October saw a seven month rally broken in the Australian equity market, as the S&P/ASX 200 Accumulation Index fell 2.1%. Global volatility returned late in October on jitters surrounding the resoluteness of the US recovery, meaning that the Australian market's 42% rally since March was brought to an end.

Outperformers during the month were defensives with Consumer Staples (up 1.4%), Utilities (up 0.6%) and Telecommunications (up 0.4%) beating the broader market. Banks (down 1.4%) were mixed but held up slightly better than the market, with the Commonwealth Bank (up 1.0%) performing best. Profit-takers significantly hindered the REIT sector, down 9.0%. Despite stronger commodity prices, where oil prices surged 12%, Mining and Energy underperformed.

Capital raisings returned to the fore with Oil Search, ING Industrial Fund and CSR among those to issue. The Myer IPO also created interest, however, after listing at \$4.10 it has been seen at \$3.88 in early November. Kathmandu is the next in line to return to public hands via an IPO.

Large Caps

The best performing Australian large-cap stocks during the month were Transurban Group (11.2%) and ConnectEast Group (11.1%).

- Transurban Group gained on the news of an in-principle agreement with the NSW Government to perform a major upgrade to the Hills M2 motorway.
- ConnectEast Group intends to use recent equity raising proceeds to repay \$505 million worth of debt facilities, with a further \$55 million in the middle of 2010. It was reported that the number of average daily trips and daily revenue had both increased in September.

The worst performing Australian large-cap stocks during the month were Caltex Australia (-15.3%) and Macquarie Group (-15.0%).

- Caltex Australia flagged a challenging second half of 2009 in its Half Year Review, as favourable conditions in the first half of the year are unlikely to remain. Also reported was their decision not to pay a dividend for 1H09 as cashflow was to be directed towards inorganic growth opportunities.
- Macquarie Group announced more acquisition activity in October - a Canadian advisory firm, Blackmont Capital for C\$93.3m and an agreement to acquire leading specialist investment bank, FKP, in the US. Also reported were normalised cash earnings for the six months to September 2009.

Small Caps

The best performing Australian small-cap stocks during the month were United Minerals (42.1%) and Perseus Mining (20.9%).

- BHP Billiton announced a conditional bid for United Minerals (UMC), a Perth-based miner. The offer is priced at \$1.30 for each UMC share, which represents a 43% premium to its last closing price prior to entering a trading halt on 6 October.
- Perseus announced details of a third capital raising this year, with plans for the \$58.5 million raising to underpin development of its flagship Ayanfuri gold project in Ghana. A joint venture contract was also awarded to South African companies DRA and Group Five for the processing of the Ayanfuri process facility.

The worst performing Australian small companies stocks during the month were Nexbis (-58.7%) and Babcock & Brown Infrastructure (-30.2%).

- Nexbis released its statutory accounts early in the month which, in the company's response to an ASX query over its share price dropping noticeably, said may have caused a shareholder reaction, as the market possibly expected higher revenues to stem from Malaysia and an update on the business' cash position.
- Debt troubled Babcock & Brown Infrastructure requested a suspension from trading early in the month as it worked through a recapitalisation plan, which was later announced in the form of a \$1.8 billion injection of new equity, involving a complicated arrangement involving Brookfield Asset Management, Credit Suisse and Macquarie Capital.

Major Indices

The major indices performed as follows during October:

S&P/ASX 200 Accumulation Index	-2.1%
S&P/ASX 200 Industrials Accumulation Index	-2.4%
S&P/ASX 200 Resources Accumulation Index	-1.2%
S&P/ASX Small Ordinaries Accumulation Index	-1.2%

Listed Property

The Australian property sector retreated 9.0% (S&P/ASX 200 A-REIT Accumulation Index) in October, underperforming the broader equity market by 6.9%. After a solid few months of outperformance, this is an unwelcome return to market underperformance.

The month was a tale of two halves, as the school holidays and a general lack of interest saw the sector trade sideways in early October, before dramatically changing from mid-month as capital raising activity re-emerged and general risk aversion returned. There was a non-renounceable rights issue and placement by ING Industrial Fund, and talk of IPO activity may have contributed to the selling pressures later in the month.

Only two stocks in the REIT sector posted a positive return for the month, however, the spread of best to worst stayed within a relatively narrow band (7.1% to -14.6%). Mean reversion seemed to be in play during the month, as last month's best performers (ING Office Fund and Charter Hall Group) were in the doldrums in October; however, ING Office Fund's rights issue and placement heavily affected this result.

Australian Fixed Income Review

The welcome improvement in the global economic backdrop continued in October. Central bankers everywhere are becoming more confident of better times ahead but understandably remain cautious. Locally, data released also remained positive. Both business and consumer confidence measures continued to rise. The labour market continues to remain relatively resilient with employers choosing to reduce the number of hours worked as opposed to reducing staff. The unemployment rate actually edged down in the latest release to 5.7%. Some may question whether the cyclical high for unemployment has been reached. The cycle low of 3.9% was in February 2008.

The ongoing improvement in the economic outlook prompted much discussion as to the appropriateness of current stimulatory policy. The Reserve Bank of Australia (RBA) had clearly flagged that current interest rate levels were at "emergency levels" and a return towards more normal levels was coming, which started in October with a 0.25% rate rise, subsequently followed by another on Melbourne Cup Day. This has brought the official cash rate to 3.50%, with a steady procession of moves throughout 2010 expected.

In terms of market moves, the benchmark 3-year bond closed higher by 0.10% at 5.14%, while the benchmark 10-year bond closed higher by 0.15% at 5.58%. The UBS Composite

Bond Index delivered a small negative return of 0.07% as capital losses from rising yields weighed on returns.

International Fixed Income Review

The global economic outlook continued to improve. In the US, Q3 economic growth registered +3.5% (seasonally adjusted annual rate), the first positive since Q2 2008. Policy remains stimulative. The labour market remains weak and job losses are still coming through even though the pace of job losses appears to be moderating. In the US, the unemployment rate edged up to 9.8% with a move beyond 10% likely before Christmas. Unfortunately the "maths" underpinning economics and labour market statistics means that it will literally take years to re-gain previous employment levels.

The debate as to the timing of when policy makers exit from extreme policy accommodation has begun. Bond yields were adversely impacted somewhat but moves were relatively muted. Clearly inflation will be a non issue for the next year or two, which may be an offsetting factor.

In terms of price action, the US Treasury 2-year note closed lower by 0.06% at 0.89% and the 10 year note, the global benchmark, closed at 3.38% higher by 0.07%. In other key global bond markets the UK 10-year Gilt closed higher by 0.03% at 3.62%, the German 10-year Bund virtually steady at 3.23% (up 0.01%), whilst the Japanese 10-year maturity closed at 1.41%, higher by 0.11%. The global fixed income market return, as measured by the Barclays Capital Global Aggregate Index (hedged into A\$) delivered a return of 0.45%.

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